

FEB 08 2006

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

IN RE:)	CHAPTER 7
)	
ANTHONY REED MIDDLEBROOKS)	
EDIE MIDDLEBROOKS)	CASE NO. 03-71937-MHM
)	
Debtors)	

ORDER SUSTAINING TRUSTEE'S OBJECTION TO CLAIM

THIS MATTER is before the Court on Trustee's Objection to a Certain Claim (the "Objection") filed June 15, 2005, and Southern Lending, L.L.C.'s ("Southern Lending") Motion to Allow Claim (the "Motion"), filed October 6, 2005. Trustee filed a response to the Motion October 11, 2005. This matter is a core proceeding pursuant to § 157(b)(2)(B) and the Court has jurisdiction pursuant to 28 U.S.C. §§ 157 and 1334. For the reasons set forth below, the Objection will be sustained and the Motion denied.

The facts of this case are simple. The deadline for filing proofs of claim in this Chapter 7 case was January 13, 2004 ("the bar date"). Southern Lending acknowledges service of the notice setting the bar date. More than a year after the bar date, Southern Lending filed its proof of claim in this case on June 7, 2005. Southern Lending seeks to have its late-filed claim, in the amount of \$1,167,783.50, allowed as timely filed.¹ Southern Lending contends that its failure to timely file its proof of claim was due to fraudulent misconduct of its senior employees.

¹ Pursuant to § 726(a), late-filed claims are subordinated to timely filed claims. See 11 U.S.C. § 726(a). Trustee anticipates that timely filed claims, which total \$117,145.42, will not be paid in full. Thus, if Southern Lending's claim is treated as a late-filed claim pursuant to § 726(a), Southern Lending probably will receive nothing.

In July, 1999, Southern Lending established a \$1,000,000 line of credit to M2 Technologies, Inc., which was guaranteed by Debtors. Southern Lending claims that the employee in charge of asset-based lending for the bank manipulated periodic reports to hide the fact that the loan was in default. Southern Lending further claims that the employee intentionally omitted the loan from the January 26, 2002 sale of Southern Lending's asset-based loans to Piedmont Bank. Southern Lending claims that, without its knowledge, the employee was negotiating future employment with Piedmont Bank and therefore had incentive to omit from the sale certain loans that were in default. The CEO of Southern Bancorp, Inc.², Mr. J. Edward Mulkey, Jr., claims that he became aware of these facts after the employee resigned in January 2002. Additionally, Southern Lending claims that the employee in charge of handling matters related to problem loans and responding to notices, such as the notice setting the bar date, failed, in dereliction of his duties, to pursue the claim on behalf of the bank. Mr. Mulkey claims that he was unaware of this fact until June 2005.

Although Southern Lending concedes that none of the exceptions for allowing a late-filed claim under Bankruptcy Rule 3002(c) apply in this case, it contends that its claim should be allowed to avoid an injustice to the bank caused by the misconduct of its employees. To support its argument Southern Lending relies on footnote 11 of *Pepper v. Litton*, 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed 281 (1939) where the Court stated:

And even though the act provides that claims shall not be proved against a bankrupt estate subsequent to six months after the adjudication, the bankruptcy court in the exercise of its equitable jurisdiction has power to permit claims to be proved thereafter in order to prevent a fraud or an injustice.

²Southern Lending is a wholly owned subsidiary of Southern Bancorp, Inc.

The Court's holding in *Pepper* laid the groundwork for equitable subordination, which is now codified by § 510(c). Collier on Bankruptcy ¶ 510.05 (15th ed. rev. 2005). The Court's statement in footnote 11 was merely an example of an instance in which the bankruptcy court had exercised its equitable powers. See *In re Imperial Sheet Metal, Inc.*, 352 F. Supp. 1149, 1153-1154 (D. La. 1973) ("The reference is found in a footnote (n. 11 of the opinion), and, it must be noted, is used not to express the court's decision on the matter pending before it, but to illustrate the generalization that the bankruptcy courts have exercised equitable power in passing on a wide range of problems arising out of the administration of bankruptcy cases."). The Court's statement in *Pepper* has been further criticized as *dictum*, as applying to the Bankruptcy Act prior to the 1938 amendments; as misleading; and as unnecessary and dubious commentary on the state of the law. *In re Martin Edsel Inc.*, 228 F.Supp. 538 (D.N.H. 1963) (citing *Arnold v. Phillips*, 117 F.2d 497, 502 (5th Cir. 1941); *In re Paragon Novelty Bag Co.*, 135 F.2d 210, 210 (2nd Cir. 1943); 3 Collier on Bankruptcy, ¶ 57.27 n. 14; *Milando v. Perrone*, 157 F.2d 1002, 1004 (2nd Cir. 1946)). Despite the Court's statement in *Pepper*, other courts have held that the bankruptcy court does not have equitable discretion to allow late-filed claims. E.g., *In re Pigott*, 684 F.2d 239 (3rd Cir. 1982); *In re Solvation, Inc.*, 48 B.R. 670, 673 (Bankr. D. Mass. 1985).

Southern Lending cites two cases in support of its argument that *Pepper* permits allowance of late-filed claims based on equitable principles: *In re Comac Co., Inc.*, 402 F.Supp. 43 (E.D.Mich. 1975) and *In re Bender Body Co.*, 47 F.Supp. 867 (N.D. Ohio 1942). In both cases, the court allowed the late-filed claims because mistakes by the bankruptcy court

officers induced the late filing. In the instant case, the fault lies not with the bankruptcy court or the debtor but with the creditor. Therefore, the cases cited by Southern Lending are inapposite.

Pepper was decided under Section 57 of the Bankruptcy Act of 1898 and former Bankruptcy Rule 302(e).³ Section 57 of the Bankruptcy Act of 1898 was the precursor to §§ 502⁴ and 726 of the Bankruptcy Code. See Collier on Bankruptcy ¶ 502.LH, ¶ 726.LH (15th ed. rev. 2005). Additionally, Rule 302(e) has been supplanted by Bankruptcy Rule 3002(c). The current Bankruptcy Code and Federal Rules of Bankruptcy Procedure, however, do not provide the bankruptcy court discretion to allow late-filed claims based on equitable considerations. See 11 U.S.C. § 502(b)(9) and 726(a); FED. R. BANKR. P. 3002(c) and 9006(b)(3).

Bankruptcy Rule 3002 provides that in cases under Chapter 7, 12, and 13 “a proof of claim shall be filed within 90 days after the first date set for the meeting of creditors pursuant to § 341(a) of the Code.” FED. R. BANKR. P. 3002(c). Rule 3002(c) provides five exceptions

³ Former Rule 302 applied only in liquidation cases except as specifically adopted by the rules regarding rehabilitative chapter cases. Collier on Bankruptcy ¶ 3002.RH (15th ed. rev. 2005). Other changes from former Rule 302 reduced the time for filing from six months to 90 days and replaced the reference to the first meeting of creditors under the Bankruptcy Act with the meeting held pursuant to section 341 of the Code. *Id.* Pursuant to Rule 302(e), with certain exceptions not relevant here, claims that were not proved and filed in the manner provided within six months after the first date set for the first meeting were not allowed. *Id.* However, under Section 57n and former Rule 302(e)(5), if all claims allowed had been paid in full, the court could permit filing of the claims that had not been filed within the prescribed time against any remaining surplus. *Id.* at ¶ 726.LH. Section 57(n) was repealed in 1978, when the new Act was passed. *In re Vertientes, LTD.*, 845 F.2d 57, 59 (3rd Cir. 1988). § 57(n) of the former Act and Rule 302(e)5 appear to have merged into 11 U.S.C. § 726(2).

⁴ In 1994 Congress added § 502(b)(9) to settle the dispute among the courts regarding the treatment of late-filed claims and to overrule *In re Hausladin*, 146 B.R. 557 (Bankr.D.Minn. 1992), in which the court held that no statutory basis existed for disallowing a late-filed claim. *In re Jensen*, 2005 WL 3144064, *2 (Bankr.M.D.Fla. 2005). Section 502(b)(9) states that a claim shall be allowed, “except to the extent that . . . (9) proof of such claims is not timely filed.” 11 U.S.C. § 502(b)(9).

under which a late-filed claim can be allowed as timely filed *after* the requisite 90 days expires.⁵ Rule 9006(b)(3), which states “[t]he court may enlarge the time for taking action under Rule 3002(c), only to the extent and under the conditions stated in those rules,” further limits the bankruptcy court’s authority to allow late-filed claims as timely filed to those instances where the exceptions under Rule 3002 apply. See *In re Jensen*, 2005 WL 3144064, at 3; *Dicker v. Dye (In re Edelman)*, 237 B.R. 146 (9th Cir. 1999); *Zidell, Inc. v. Forsch (In re Coastal Alaska Lines, Inc.)*, 920 F.2d 1428 (9th Cir. 1990); *In re S.A. Morris Paving Co.*, 92 B.R.161, 163 (Bankr.W.D.Va. 1988); see also *In re Guarantee Electric, Inc.*, 91 B.R. 164, 165 (Bankr.M.D.Fla. 1988); *In re Wilson*, 90 B.R. 491, 493 (Bankr.N.D.Ala. 1988); *Miller v. Austin*, 72 B.R. 893, 894, 897-98 (S.D.N.Y. 1987). Thus, § 502(b)(9), Rule 9006(b)(3), and Rule 3002(c) prohibit late-filed claims unless they are filed under § 726(a)⁶ or otherwise

⁵Rule 3002(c) permits claims to be timely filed beyond the 90 day requirement as follows:

(1) A proof of claim filed by a governmental unit is timely filed if it is filed not later than 180 days after the date of the order for relief. On motion of a governmental unit before the expiration of such period and for cause shown, the court may extend the time for filing of a claim by the governmental unit.

(2) In the interest of justice and if it will not unduly delay the administration of the case, the court may extend the time for filing a proof of claim by an infant or incompetent person or the representative of either.

(3) An unsecured claim which arises in favor of an entity or becomes allowable as a result of a judgment may be filed within 30 days after the judgment becomes final if the judgment is for the recovery of money or property from that entity or denies or avoids the entity's interest in property. If the judgment imposes a liability which is not satisfied, or a duty which is not performed within such period or such further time as the court may permit, the claim shall not be allowed.

(4) A claim arising from the rejection of an executory contract or unexpired lease of the debtor may be filed within such time as the court may direct.

(5) If notice of insufficient assets to pay a dividend was given to creditors pursuant to Rule 2002(e), and subsequently the trustee notifies the court that payment of a dividend appears possible, the clerk shall notify the creditors of that fact and that they may file proofs of claim within 90 days after the mailing of the notice.

FED.R.BANKR.P. 3002(c). Rule 3002(c) formerly provided six exceptions, however, the sixth exception was eliminated by amendment in 1996 to conform with §§ 502(b)(9) and 726 as amended by the Reform Act of 1994. Collier on Bankruptcy ¶ 3002.RH.; see also *In re Edelman*, 237 B.R. 146, 152 n.7 (9th Cir. 1999).

⁶Section 726 provides an additional exception under which a late-filed claim may be allowed as timely filed: if the creditor did not receive notice and files the proof of claim before the distribution. 11 U.S.C. § 726(a).

permitted under the Federal Rules of Bankruptcy Procedure. *Jensen*, 2005 WL 3144064, at *2. The bankruptcy court does not have the equitable power to allow a late-filed claim as timely filed where it does not fall under one of the exceptions provided in Rule 3002 or § 726. *See, Gardenhire v. IRS (In re Gardenhire)*, 209 F.3d 1145 (9th Cir. 2000); *In re Coastal Alaska Lines*, 920 F.2d 1428, 1432-33 (9th Cir. 1990); *In re Husman*, 276 B.R. 596, 598 (Bankr. N.D.Ill. 2002); *In re Valerino Constr., Inc.*, 275 B.R. 684, 687 (Bankr. W.D.Tex. 2002); *In re Ryan*, 54 B.R. 105 (Bankr. E.D.Pa. 1985); *In re Sullivan*, 36 B.R. 771 (Bankr. E.D.N.Y. 1984); *Matter of Revere Copper and Brass, Inc.*, 58 B.R. 1 (Bankr. S.D.N.Y. 1985).

Even in a case where the failure to file a claim was due to “an act of God” and was not the result of any wrongdoing by the creditor, the Ninth Circuit held in *Edelman*, the bankruptcy court did not have discretion to allow the late-filed claim. 237 B.R. at 153. In that case the lawyer for the creditor failed to timely file a proof of claim because he was unable to enter his office for several days following an earthquake. *Id.* at 148. Relying on *Coastal Alaska*, 920 F.2d 1428 (9th Cir. 1990), the court held that it did not have the authority to extend the time for filing a claim where none of the exceptions under Rule 3002 applied. *Id.* at 152. The court further stated, “The rule of *Coastal Alaska* simply is that no source of discretion exists--neither equitable jurisdiction, nor § 105, nor anything else--and a source is not created even if a good reason is presented for why a source *should* exist.” *Id.* at 153.

Southern Lending concedes that none of the exceptions provided in Rule 3002(c) or § 726(a) apply in this case. Therefore, its claim cannot be allowed as timely filed. Furthermore, in this case, even if the bankruptcy court had discretion to allow the late-filed claim, Southern Lending has not demonstrated that the equities are in its favor. Neither

Debtor, the Trustee, nor any creditor contributed to Southern Lending's failure to timely file its claim. If Southern Lending's claim is allowed, however, it will significantly reduce the distribution to other unsecured creditors who timely filed their claims in this case. "These other creditors are entitled to assume that this court will enforce the rules in the distribution of this estate." *In re Underground Utility Construction Co., Inc.*, 35 B.R. 588, 589 (Bankr.S.D.Fla. 1983); *see also In re Solvation, Inc.*, 48 B.R. at 674. Southern Lending received notice of the bar date. The fraud that Southern Lending complains of occurred two years prior to that date. Southern Lending had time to investigate the status of the loan and timely file a proof of claim. Southern Lending has failed to show that the injustice it seeks to avoid, alleged fraud by its own employees, should be absorbed by the other unsecured creditors in this case. Accordingly, it is hereby

ORDERED that Trustee's objection to the claim of Southern Lending is **SUSTAINED**.

It is further

ORDERED that Southern Lending's motion to allow claim is **DENIED**.

IT IS SO ORDERED, this 7th day of February, 2006.



MARGARET H. MURPHY
UNITED STATES BANKRUPTCY JUDGE